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ABSTRACT

This report analyzes the factors involved in reviewing benefits and services of employer-sponsored group long-term disability plans for higher education institutions. Opening sections describe the evolution of disability insurance and its shape today. Further sections looks at the complex nature of "value" within a plan, relationship between plan design and cost, and components of plan design including benefit level, waiting periods, length of elimination period, definitions of disability, partial disability, preexisting conditions, duration of benefits, annual benefit increase, conversion privilege, survivor income benefit, and annuity premium benefits. A section on asking insurers unanswered questions about plan provisions mentions several questions to consider and outlines key areas to explore in a proposal review. Further sections review the process whereby costs are determined between the insurer's actuarial department and other parts of the process, discuss cost comparisons and questions, and raise important issues of financial stability. (JB)

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Research Dialogues

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Evaluating Long-Term Disability Insurance Plans

This issue of Research Dialogues *explores the factors involved in reducing benefits and services of employer-sponsored group long-term disability plans. Our aim is to provide a perspective on the plan options available and to satisfy employers' needs for information regarding the "real cost" of long-term disability insurance.*

Introduction

Group disability insurance can be traced from imperial Rome to the "Friendly Societies" of nineteenth-century Britain to today's insured-benefits plans. And while the history is diverse, the focus is simple: to provide adequate income replacement during periods of total physical disability at the lowest possible cost.

"Simplicity," however, does not describe the current benefits environment for plan administrators. Caught in the conflicts of budget restraints, labor demands, the need for attractive benefits packages, and a stream of marketing materials, the benefits administrator must have a very discerning eye to evaluate group benefit plans.

The Evolution of Group Long-Term Disability Insurance

Artisans in imperial Rome, the craft guilds of medieval England, and the Friendly Societies of Britain are the earliest examples of groups who banded together to spread the personal economic risks of injuries and illness. As the Industrial Revolution spread throughout Europe, systems of mutual aid also developed in Germany, Scandinavia, Switzerland, and the Netherlands. These were often called "sick clubs," or "mutual benefits funds." Usually, small contributions were collected from the membership in return for the promise to pay a cash benefit when the member became ill or disabled. In effect, this type of mutual aid was what we refer to today as short-term disability insurance.

In 1851, one of the first mutual protection associations in the U.S., La Société Française de Bienfaisance Mutuelle, was organized in San Francisco.[1] Starting in 1875, a number of similar associations, called "establishment funds," were formed by and for the employees of a single employer. These funds were judged inadequate, however, because of their purely volunteer character, poor participation from eligible workers, and low levels of contributions.

The twentieth century brought the enactment of workers' compensation laws in the U.S., first by the federal government in 1908, followed by the state of Wisconsin in 1911.[2] While these laws were welcomed by employees, the need remained for a means of providing benefits for illness and nonwork injuries. Montgomery Ward & Co., which had introduced the nation's first group life insurance plan, took the lead in developing an insured disability plan for its employees. In 1911, it placed its disability income coverage with the London Guarantee and Accident Company of New York. After a three-day waiting period, the contract provided benefits for disabled employees under age 70 equal to one-half of their weekly wage, subject to a minimum benefit of $5 per week, and a maximum benefit of $28.85 per week.[3]

Long-Term Disability Insurance Today

Early long-term disability plans (LTD) were designed to provide coverage (for up to five years) for certain high-salaried employees. Today, plans cover all classes of employees with many benefit features, flexibilities, and premium levels.

In general, long-term disability benefits usually begin after six months of disability or after sick leave and short-term disability benefits end. They continue until retirement age, the end of the disability, or a specific number of months, depending on the employee's age at disability. (If the employee is disabled after age 60, benefits usually continue for five years or to age 70, whichever is sooner.)

A 1989 Department of Labor survey, based on full-time employees in a cross section of private industries with at least one hundred employees, indicates the extent of long-term disability coverage in medium and large firms:

- Forty-five percent of all full-time employees had long-term disability insurance.

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Unlike the continually rising costs connected with health insurance plans, long-term disability insurance rates have remained relatively stable in recent years.

- White-collar workers were more than twice as likely to have long-term disability insurance compared with production/service workers.
- About 86 percent of participants were in plans paying a fixed percentage of income.
- About 20 percent were in contributory plans. The most common employee contribution was between $0.20 and $0.39 per $100 of covered earnings.[4]

The Concept of *Value*

Determining the cost of a long-term disability plan begins with the concept of *value*. What does the employer value? Of what value are the plan's benefits to the employee?

During a person's working years, the risk of incurring a long-term total disability is only slightly less than the risk of death, a risk that is commonly covered through individual or group life insurance. This perhaps surprising fact is disclosed by actuarial data that show that the chance of becoming totally disabled before age 65 for a period of six months or more is on the average nearly one out of five for men aged 25 to 45, although somewhat less at the higher ages, while the probability of dying before age 65 is not substantially different. For women, the probability of a total disability is substantially greater than the probability of dying before age 65.[5] But the financial consequences of total disability can be insured against at a rate well below the cost of insuring automobiles.

The basic function of an employer-sponsored long-term disability plan is to provide the employee with income protection during total disability *(income benefit)*. Two more benefits considered worthwhile by employers and insurers are: inflation protection for the disability income *(annual benefit increase)* and adequate retirement income through continued funding of the individual's retirement account during disability *(annuity premium benefit)*.

Employers recognize the value of an attractive and competitive benefits package for employee recruitment and retention, even in today's tight job market. And the educational community in particular is especially sensitive to providing for its employees' needs.

Long-term disability plans have the additional appeal of providing relative cost stability: Unlike the continually rising costs connected with health insurance plans, long-term disability insurance rates have remained relatively stable in recent years. As noted in the April 1991 issue of *Research Dialogues*, in the 1977-1989 period studied, the average employer expenditure in higher education as a percent of payroll for long-term disability benefits remained unchanged, with a slight decrease in 1987.[6]

For employees, an important measure of the true value of a long-term disability plan is its ability to provide protection at a reasonable cost. But at the same time, the plan should provide every incentive for employees to return to work. This helps moderate the cost of the program for the employer, and enhances the employee's long-term earnings growth potential.

Plan Evaluation: Relationship of Benefits to Price

What factors determine the real cost of a long-term disability plan? Today's often stormy financial atmosphere seems to offer one constant: the temptation to look only at premium rates. To most benefit plan administrators, rates may appear to be "the bottom line." Others hold a more inclusive view of long-term disability programs and their effect on the institution. They look well beyond the bottom line for information. This is not to imply that rates are of little concern, but a balanced perspective is needed—a perspective essential to any purchase decision.

In an evaluation of long-term disability plans, a first consideration is plan design, and then insurance rates. These two elements affect each other, and the decisions about them will influence the overall effectiveness of the plan.

Plan Design

The Benefit Level Since the two-fold purpose of long-term disability insurance is income protection and incentive to return to work, a major consideration must be the level of the monthly income benefits.

Studies by the Society of Actuaries show how the level of benefits affects (1) the "loss ratio," i.e., the amounts paid out in benefits by the insurer compared with the amounts received in premiums, and (2) the employer's claims experience. For example, the studies show that employers offering 70-79 percent of pretax wages as a benefit can expect a loss ratio about 25 percent higher than a plan providing 60-69 percent of pretax wages.[7]

Thus, from the employer's perspective, employees who remain out of work continue to affect plan experience; and providing too high a benefit can neutralize the plan's cost-containment structure. But while a higher income benefit may help employees in the short term, the proportionate lack of financial incentive to return to work may seriously harm their long-term fi-

nancial well-being. Adequate long-term disability benefits that offer the employee a personal financial incentive to return to work can contribute both to the financial integrity of the plan and to the employee's long-term interests.

Table 1 shows the distribution of monthly long-term disability income benefits in TIAA plans. As indicated, 87 percent of total plans use a benefit level of 60 percent of salary.

Waiting Period The waiting period for plan participation is the length of time before newly hired full-time permanent employees in a class eligible for long-term disability plan participation are brought into the plan. Table 2 shows the waiting periods in effect in TIAA long-term disability plans. Of total plans, slightly more than a quarter provide for a waiting period of three months or less, and 61 percent have set a waiting period of one year or more.

Length of Elimination Period The elimination period (also known as the benefits waiting period) is the length of time following the start of an insured individual's disability that is prescribed before long-term disability benefits begin. The elimination period is usually set at six months following the onset of disability. In determining the elimination period, it is appropriate to ask what benefits the institution already provides for disabled employees. Is there some type of salary continuation such as sick-leave accumulation or short-term disability income? For how long is it provided? This will affect the choices made regarding the length of the elimination period.

Definition of Disability Another question is how the plan's definition of disability accomplishes the institution's objectives. (See Figure 1 for various definitions of disability.) Will it be preferable to offer a "lifetime regular occupation" definition, or a "two-year regular occupation" definition, providing for partial disability benefits?

Table 1

Income Benefit as Percent of Salary
TIAA Long-Term Disability Insurance Plans

	60 Percent of Salary		66 2/3 Percent of Salary		60 Percent, Portion 40 Percent, Remainder		Other		Total	
	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent
All institutions	1,246	87%	23	2%	130	9%	28	2%	1,432	100%
Four-year colleges and universities	411	83%	15	3%	54	11%	15	3%	495	100%
Two-year colleges	41	66%	1	2%	16	25%	4	7%	62	100%
Independent schools	291	90%	3	1%	29	9%	1	*	324	100%
Other	503	91%	9	2%	31	6%	8	1%	551	100%

*Less than 1 percent

Source: TIAA Group Insurance Services division, Policyholder Services unit

Table 2

Waiting Period Before Plan Participation Begins
TIAA Long-Term Disability Insurance Plans

	3 Months or Less		4 to 5 Months		6 Months		1 Year or More		Other		Total	
	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent
All institutions	372	26%	14	1%	29	2%	874	61%	143	10%	1,432	100%
Four-year colleges and universities	103	21%	7	1%	4	1%	304	61%	77	16%	495	100%
Two-year colleges	15	24%	-	-	1	2%	42	68%	4	6%	62	100%
Independent schools	113	35%	-	-	9	3%	186	57%	16	5%	324	100%
Other	141	26%	7	1%	15	3%	342	62%	46	8%	551	100%

Source: TIAA Group Insurance Services division, Policyholder Services unit

What is the difference in cost? What effect would offering a "lifetime own occupation" definition have on claims experience? Which approach offers the best incentive for all classes of employees to return to work?

A popular disability definition developed for professional-level employees is "lifetime own occupation," coupled with partial disability benefits. The partial provision serves to recognize earnings while working in other fields, or in the same field (occupation), on a part-time basis. The success of this structure depends on an employee's personal motivation to work up to full potential.

Professionals, who have invested a great deal of time and resources in their careers, are likely to be well motivated to resume a career. For nonprofessionals, a dual type of definition affords—after an "own occupation" disability period—an opportunity to be employed in another capacity without extensive retraining. Knowing that a period of "own occupation" disability (usually set at two to five years) will end may strongly encourage nonprofessional employees to pursue some type of retraining for less active positions, such as security guard or bookkeeper.

Partial Disability What about the employee who because of a disabling condition cannot work full-time, but can continue to work part-time? Many institutions provide benefits on either a partial or a residual basis. With a partial disability benefit plan, an employee who is deemed totally disabled from performing his or her own occupation may return to work part-time (after satisfying the elimination period) and receive disability benefits along with some salary.

For example: An employee earns $2,000 per month prior to disability. Through rehabilitation, this person returns to work part-time, earning $1,000 per month. Under a partial disability plan, since earnings are one-half of previous salary, one-half of a total disability benefit would be paid. Since the benefit is 60 percent of salary, the employee would receive a benefit equaling 30 percent of previous salary. This benefit is attractive to many employers since it lowers the cost of the plan and returns valuable employees to work.

A residual benefit would be paid to the person who is never declared totally disabled, but cannot work full-time. In this case, an individual who is disabled can continue to work during what would normally be the elimination period, and can qualify for benefits. An example of someone receiving residual disability benefits would be a person who suffers from a chronic back problem. This person is able to work part-time without extended ab-

Figure 1
Definitions of Disability

Definitions of disability vary. The following are definitions used by TIAA.

Any Occupation

Being unable due to sickness, bodily injury, or pregnancy to perform any occupation for which the employee is reasonably suited by education, training, or experience. The employee must be under the regular care of a physician other than himself or herself.

(This definition is narrowly administered. A professor would not be expected to perform nonprofessional clerical work, but a surgeon could be expected to perform as a general practitioner.)

Dual Definition

A. For the first ___ months of total disability, being completely unable due to sickness, bodily injury, or pregnancy to perform the employee's normal occupation; and

B. After the first ___ months, being unable due to sickness, bodily injury, or pregnancy to perform any occupation for which the employee is reasonably suited by education, training, or experience.

For both A and B above, the employee must be under the regular care of a physician other than himself or herself.

Working Lifetime Normal Occupation, Partial Disability

A. Being completely unable due to sickness, bodily injury, or pregnancy to perform the employee's normal occupation and not performing any other occupation; or

B. Working, but being unable due to sickness, bodily injury, or pregnancy to earn more than 80 percent of his or her increasing monthly wage base.

For both A and B above, the employee must be under the regular care of a physician other than himself or herself.

Source: TIAA Group Insurance Services division, Technical Support (Underwriting) unit

Generally, the last benefit payment is made when the disability ends, or when the individual reaches the institution's retirement age, usually defined as the normal age of 65.

sences and, therefore, without being declared totally disabled.

Thus, under partial disability, an elimination period is satisfied and the person is declared totally disabled; thereafter, he or she returns to work on a part-time basis. Under residual disability, during the elimination period the person works part-time, thus qualifying for disability benefits without ever being declared totally disabled.

Preexisting Conditions A preexisting condition exclusion protects the plan against adverse selection. It is applied when the employee becomes insured under the plan immediately upon employment. Under a typical preexisting condition exclusion, benefits are not payable for a disability caused by an illness, injury, or pregnancy that started before the employee became insured under the plan. The preexisting condition exclusion is waived if, for twelve months prior to the start of disability, the employee was insured for long-term disability benefits under the current plan, or under any other plan prior to the current coverage.

Duration of Benefit After total disability benefits start, they continue to be payable each month during continuous total disability. Generally, the last benefit payment is made when the disability ends, or when the individual reaches the institution's retirement age, usually defined as the normal age of 65. However, for individuals age 60 or over when disability starts, there is a provision for a maximum duration of benefits. A commonly used schedule of benefit duration for a plan with a six-month elimination period is the following:

Age Total Disability Starts	Maximum Duration of Benefits
Less than 60	To age 65
60 but less than 65	4 1/2 years
65 but less than 68 1/2	To age 70
68 1/2 or over	1 year

Annual Benefit Increase Inflation affects disabled persons just as it does everyone else. To help compensate for the effects of inflation over periods of disability, which in some cases may be quite lengthy, some institutions include in their long-term disability plan a provision for an annual benefit increase. In TIAA long-term disability plans, a 3 percent or a 5 percent annual increase can be selected. Seventy percent of TIAA long-term disability plans have incorporated an annual benefit increase provision.

Conversion Privilege Some plans allow employees terminating employment to continue (at their own expense) long-term disability insurance coverage for the income benefit, within a stated maximum, by means of a privilege of conversion to individual coverage. While this privilege is not legally required, it gives employees the opportunity to continue a level of total disability insurance on their own after employment terminates.

Survivor Income Benefit This provision allows for the continuation of benefits to the spouse or child of an employee who dies while collecting disability income benefits. It can be an attractive addition to the benefits roster because of the benefit to the employee's beneficiary and its relatively low cost.

Annuity Premium Benefit This provision, separate from the main income benefit, allows for the continuation of contributions to the disabled person's retirement annuities for as long as he or she remains disabled. In effect, it ensures that the disabled employee will continue to receive sufficient income until retirement, when disability benefits cease and retirement income begins.

The dollar amount of the annuity premium benefit is based on a percentage of salary equal to, or substantially equal to, the contribution rate applied under the employer's retirement plan just prior to disability. The insurance rate for the annuity premium benefit is usually stated separately from the rate for the income benefit. Ideally, when disability benefits start, the annuity premium benefit flows into the employer's regular retirement plan and, under it, into the funding accounts chosen by the employee. The annual benefit increase provision may also be applied to the annuity premium benefit.

Availability and flexibility of benefits are key considerations in an evaluation of plan provisions. Except for the conversion privilege and the survivor income benefit, the various features described above are considered basic to a strong plan.

Asking an Insurer Unanswered Questions about Plan Provisions

Support services that help contain the costs of disability benefits should always be considered. Are rehabilitation services offered? What degree of flexibility in administration of rehabilitation ser-

vices does the insurer offer? Does the insurer offer assistance in obtaining Social Security benefits? What is the insurer's track record in obtaining such benefits? What are the limits of these services? Are on-site risk-management services supplied by the insurer? For example, will the insurer contract with a local agency to go to the institution and inspect areas where injuries or illnesses frequently occur? These and other questions related to the insurer's commitment to cost containment are extremely important when discussing the real cost of any plan.

During a proposal review, the details of some provisions or limitations that have a significant impact for certain disabilities—and the cost of the plan—should not be overlooked. These include:

- ▲ Exclusions and limitations applicable to mental and nervous disorders and disabilities caused by alcoholism and drug addiction. (Less than one percent of TIAA long-term disability plans limit benefits for mental illness.)
  - Consideration should be given to whether the plan should treat each disabled employee alike, no matter what the condition causing disability.
  - Great care should also be taken to define how the institution treats disabilities arising from substance abuse. A disability insurer can be of help here, e.g., providing cost illustrations of various types of coverage.
- ▲ The length of the benefits period if disability begins after age 60.
- ▲ The entity to which the annuity premium benefit is to be paid.

  Are premiums to be paid directly to the annuity provider? Put into an interest-bearing account? Are they to be applied to a regular retirement annuity, supplemental retirement annuity, or other accounts? If the plan has an annual benefit increase provision, does it apply to this benefit as well as to the income benefit?

Cost of the Plan

Both actuarial and underwriting considerations determine the cost of a long-term disability plan. As a matter of necessity, plan administrators have become well versed in these disciplines as they relate to the pricing of long-term disability plans. It may be of some interest to take a small step back and review the interaction that takes place before rates are presented.

The role of the insurer's actuarial department is to provide its underwriters with a set of assumptions on which to overlay the employer's census data. To produce the assumptions, an actuary establishes "cells" containing prototypical employees (in the example below, white-collar females, age 50, with $3,000 of monthly salary). Then a calculation is made:

Benefit = 60% of monthly salary = $1,800

Estimated Social Security benefit = $800

Estimated net benefit = $1,000

The probability of becoming disabled is 6 out of 1,000 lives = .006 in a year

The estimated present value of a $1,000 monthly payment that may be payable to age 65 and *the probability of not remaining disabled* (duration of disability) = $100,000

Monthly cost of benefit = (1/12) (.006) ($100,000) = $50 (plus expenses, usually 10% of premium)

This is the claim-cost part of a manual, i.e., not experience-rated, premium rate. Underwriters then apply census data to determine the final rate.

Rates are also influenced by the plan's own claims experience in plans that insure large numbers of employees.

Experience is applied by "pooling" or "self-rating." In the case of pooled rates, the average experience of the pool is applied directly to the actuarial model, and the rates are then determined. (At TIAA, this pooling is done for institutions with five hundred or fewer insured employees.)

In the case of large institutions, where a plan's own claims experience (average of total paid benefits plus changes in claim reserves over the four prior years) has greater credibility and is easier to predict, underwriters may use a combination of pooled and institution-specific experience on which to base their assumptions and determine rates. Rates for very large institutions, with perhaps five thousand or more insured employees, would be based exclusively on the individual institution's claims experience. Again, this information is applied to the rate model and the actual rate is then determined.

General cost parameters are hard to set. According to TIAA's Underwriting unit, based on the plan design and the composition of an insured group of employees by age, sex, and occupation, costs for long-term disability coverage (expressed as a percent of the payroll for the insured group) range from 0.25 percent of payroll on the low end to 0.80 percent on the high end.

Cost Comparisons and Questions

Primary to a cost comparison among competing insurers is the assurance that each insurer's price is illustrated on a common basis, i.e., per $100 of covered salary or per $100 of benefits. The same commonality must also be true for the use of claims assumptions.

The ability to provide efficient claims evaluation, federal and regulatory information and forms assistance, correct billing information, plan documents, and help in enrollment, all affect the overall well-being of an institution's benefits package—and its benefits staff.

For fully self-rated plans, questions regarding how premium dollars are used by the insurer should be asked. Questions concerning key interest rates apply here. For example:

- What interest rate assumption is used to set reserves, which reflects the present value of future benefits payments? (Current interest discount rates range between 5 and 8 percent.)
- What level of interest is credited on the accumulated dollar amount of reserves as more claims are added from year to year?
- What portion of each premium dollar is *not* used to fund benefit payments or reserves? How much covers risk charges, administration expenses, commissions, profit margins, acquisition charges, claims and contract administration fees, etc.?
- In case of plan termination, during the "run-out period" (which usually lasts for twenty-four months starting at the plan's termination date), does the employer continue to get reserves credited back for disabled individuals who return to work or die? What about interest earned during this period? Is there a difference in how these credits are handled if the plan is terminated on or off its anniversary date?

Other Cost Considerations

Plan administration, benefits payments, marketing, the insurer's service commitment, and the insurer's distribution system are also relevant to overall cost.

The ability to provide efficient claims evaluation, federal and regulatory information and forms assistance, correct billing information, plan documents, and help in enrollment, all affect the overall well-being of an institution's benefits package—and its benefits staff. Insurers with minimal distribution costs (e.g., who use a non-commissioned sales force) and substantial cost-containment services, such as risk-management, rehabilitation, and Social Security Assistance programs, can offer policyholders enriched plans, perhaps with leaner rates.

Other flexibilities, such as Administrative Services Only (ASO) availability and a menu of plan enhancements, provide opportunities for well-tailored plans that meet specific needs.

Issues Concerning Financial Stability

The solvency of the insurer is paramount in choosing a plan. Great care must be taken to select a carrier whose financial strength and claims-paying ability are reflected by high ratings given by leading independent rating firms. An insurer's history, the strength of its reserves, the key interest rates it pays, its administrators, and the types of investments it makes reveal much about the insurer whose proposal is under consideration. The cost of not knowing the insurer too often makes the selection one of the most expensive decisions an administrator makes.

Conclusion

Finding the "right" long-term disability plan—at the right cost—often requires a major investment of time and energy by administrators and their staff.

Valuable time is spent contacting insurers and evaluating suggested benefits and rates. Budgets that frequently suffer cuts at the state and local levels must support efforts to find attractive and affordable benefits.

Sifting through insurance marketing materials, quotes, questions, and the concerns of employer and employees is never easy. Decisions must be carefully made. It is hoped that the factors described in this issue of *Research Dialogues* can assist administrators in reviewing or upgrading an existing long-term disability plan, or in considering the installation of a plan. *(This report was prepared for* Research Dialogues *by Jan Powell, Communications Specialist, TIAA.)* ❑

Endnotes

[1] Health Insurance Association of America, *A Course in Group Life & Health Insurance*, Part A (Washington, D.C.: HIAA, 1979), 8.

[2] Ibid.

[3] Ibid., 9.

[4] U.S. Department of Labor, Bureau of Labor Statistics, *Employee Benefits in Medium and Large Firms, 1989*, bulletin 2363 (Washington, D.C.: Government Printing Office, June 1990), 20-21.

[5] Francis P. King and Thomas J. Cook, *Benefit Plans in Higher Education* (New York: Columbia University Press, 1980), 208, table 8.1.

[6] TIAA-CREF, "Trends in Payments for Employee Benefits—A Review of the TIAA-CREF Retirement and Insurance Benefits Cost Surveys, 1977-1989," *Research Dialogues*, no. 29 (April 1991): 5.

[7] Society of Actuaries, "Group Long-Term Disability Insurance," *Transactions: 1984 Reports of Mortality, Morbidity and Other Experience* (St. Joseph, Michigan: Imperial Printing Company, 1988), 262, table I-8.